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Before the
Federal Communications Commission
Washington, D.C. 20554

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the Matter of)

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Access Charge Reform)

CC Docket No. 96-262

Price Cap Performance Review
for Local Exchange Carriers)

CC Docket No. 94-1

Transport Rate Structure
and Pricing)

CC Docket No. 91-213

Usage of the Public Switched
Network by Information Service
and Internet Access Providers)

CC Docket No. 96-263

Request for Late Filing

Citizens for a Sound Economy Foundation (CSE Foundation) requests permission to submit, one day following the Commission's deadline, the attached comments in the above-referenced proceeding. Due to unforeseen circumstances, we were unable to complete our comments prior to this time, but we believe a one day delay would not prejudice any party in this proceeding.

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Comments of Citizens for a Sound Economy Foundation

Citizens for a Sound Economy Foundation (CSE Foundation) supports reform of the current policies concerning access charges for use of the local switched telephone network. Founded in 1985, CSE Foundation is a nonprofit research and educational organization with 250,000 members and supporters in every state in the country. We have been active in a broad range of telecommunications policy concerns since 1987, addressing such issues as universal service, price regulation, and use of the electromagnetic spectrum.

We believe that substantial reform of access charge regulations is necessary to meet the requirements set out by the Telecommunications Act of 1996. Specifically, we believe that the current approach promotes inefficiencies, and that the maintenance of access charge regulations in those markets where competition exists is antithetical to both an efficiently functioning market and the interests of consumers.

CSE Foundation notes that the Federal Communications Commission (FCC) offers significant alternatives to its current regulatory approach to access charges, including what it calls a "market-based" approach and a "prescriptive" approach. We believe that a market-based mechanism offers large potential advantages, including a lower amount of intervention by regulators and a more clear cut process for moving to a deregulated market. It is this rapid move to competitive and deregulated markets that will most benefit consumers. For this reason, we strongly believe that the Commission should define a point at which complete deregulation of access charges can take place. Such a point, however, should not be determined by arbitrary requirements on market share, but should instead recognize the competition that comes from potential new entrants in a market.

I. Inefficiency in Regulation and the Need for Reform

In this proceeding, the Commission recognizes that the existing arrangement for pricing access to local exchange markets is inefficient and unsustainable in a competitive environment.¹ As a result, it attempts to both present mechanisms for regulating in those markets deemed less-than-competitive as well as evaluate the point at which markets might be deemed competitive.

Significantly, the Commission has stated that its goal is to "foster the development of substantial competition for interstate access services."² Citizens for a Sound Economy Foundation concurs with this goal, and we further note that success in this effort should be followed by eliminating regulation from these competitive markets.

In addition, we note that continued regulation in the presence of competition may keep in place inefficiencies, and will ultimately be detrimental to consumers. This is true for regulation in a variety of telecommunications markets. To its credit, the Commission recognized the inherent problems with maintaining price cap regulation in the long-distance market, and in 1995 removed a regulatory structure that paralleled today's price cap structure used for regulating access charges.³ In this current access charge debate, the Commission

¹ "In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, and Usage of the Public Switched Network by Information Service and Internet Access Providers," Notice of Proposed Rule-making, Third Report and Order, and Notice of Inquiry ("NPRM"), CC Docket No. 96-262, CC Docket No. 94-1, CC Docket No. 91-213, CC Docket No. 96-263, December 24, 1996.

² NPRM, Para. 149.

³ See Revisions to Price Cap Rules for AT&T Corp., CC Docket No. 93-197, Report and Order, 10 FCC Rcd 3009 (1995).

has noted that its current pricing structure may create just such inefficiency, observing that "our rate structure rules do not send accurate pricing signals to customers, and consequently, encourage inefficient use of telecommunications services."⁴

We commend the Commission for focusing on the need for accurate pricing signals. Indeed, failure to overcome this problem creates multiple inefficiencies in the industry. As the Commission rightly notes, inaccurate prices give the wrong incentive for use of the network. For example, overpriced long-distance services means that some toll calls are not placed that otherwise would have been placed. Economically efficient behavior (i.e., placing the calls) does not occur.

In addition, not only do inaccurate prices give the wrong incentive for use, they also give the wrong incentive for investment. For example, if local service is underpriced, new entrants have no incentive to invest in the capital necessary to provide this service. Such a result will lead to less capital investment in the local loop and may forestall competition in this market.

Of course, it is very difficult to design regulatory arrangements that send accurate price signals. But this only further illustrates the need for competitive markets, which, when left unregulated, send accurate price signals and thus encourage efficient use and investment. For those markets in which regulation continues due to lack of competition, the Commission outlines two different approaches towards regulation -- a "market-based" approach and a prescriptive approach -- as well as the opportunity to offer some combination of these.

Citizens for a Sound Economy Foundation notes that both approaches, as proposed by

⁴ NPRM, Para. 55.

the Commission, should be considered as temporary regulatory structures, not as goals in and of themselves. That is, they should be considered as alternative frameworks designed to provide for more efficient regulation in the interim prior to reaching what is the real goal: competitive markets.

We also note that the choice of approach may affect how fast or even whether we achieve this end of competition in the market for access services. In short, we believe that the choice of regulatory structure in the interim before competition is not insignificant. And as we illustrate below, one of these approaches is clearly superior in achieving our goals.⁵

II. The Prescriptive Approach to Regulating Access Charges

With regard to the prescriptive approach to reforming access charges, Citizens for a Sound Economy Foundation is particularly concerned about the ramifications of adopting such a measure. First, as compared to alternative models, this approach has the potential to give a larger role to the Commission or other regulators in this industry, a point noted in the NPRM in the instant proceeding.⁶ Such increased regulatory involvement likely would place paperwork and other administrative burdens on both the Commission and reporting carriers. Of course, these burdens ultimately are shouldered by ratepayers or taxpayers.

⁵ Admittedly, the use of the most efficient regulatory structure for regulated markets plays only one role in influencing the arrival of competition. Appropriate mechanisms are also needed for the other major pieces of reform as dictated by the Telecommunications Act of 1996 -- universal service and interconnection.

⁶ NPRM, Para. 218.

Second, and more importantly, a large role for a regulatory authority exacerbates a particularly difficult problem -- the fact that experts cannot accurately estimate the correct price for access services or any other good or service outside of the marketplace. Yet the proposed prescriptive approach to regulating access charges sets up the possibility that economic models -- not market considerations -- will determine the "appropriate" price. True, most economic models make efforts to incorporate characteristics of the market being evaluated. But all models will ultimately have to deal with estimation error, and those that are based on prescriptive approaches are perhaps least able to deal with such miscalculation.⁷

This potential for serious error in the calculation of an "appropriate" access charge results in the constant threat of under- or over-investment. In fact, the problem is analogous to that of using a prescriptive approach in setting rates for basic local service. Just as local rates that are capped below the market price discourage infrastructure investment in these markets, so can regulated access charges set sufficiently above or below market prices distort this market. A regulatory approach that sets access fees below a market price, for example, discourages potential new entrants (e.g., resellers) from competing in this market. Such disincentives will exist to a greater degree the greater the extent to which market mechanisms are left out of the estimation process.

⁷ A long-standing literature presents the macroeconomic perspective on problems that accompany prescriptive approaches to regulating prices. See, Hayek, Friedrich, "Socialist Calculation III: The Competitive Solution," in Individualism and Economic Order, University of Chicago Press, 1948. From a microeconomic perspective, the prescriptive regulation of rates in an industry -- that is, any regulation that attempts to set rates based on an estimate of costs -- will encounter difficulties in forming an accurate estimate of the true costs of serving a particular market. See, Kahn, Alfred, The Economics of Regulation: Principles and Institutions, Vol. I, The MIT Press, Cambridge, 1995, pp. 45-53.

III. The Market-Based Approach to Regulating Access Charges

With regard to the market-based approach, Citizens for a Sound Economy Foundation recognizes that the proposed model has important benefits. Specifically, we note that this approach, as proposed by the Commission, would progressively reduce regulation in the market for access services, employing a "Phase 1" for partial deregulation in the presence of potential competition and a "Phase 2" for more significant deregulation in the presence of actual competition.⁸ Such a two-tiered mechanism would establish a largely objective criteria for when to fully deregulate access charges, and would minimize the involvement of regulatory authorities who ultimately must decide when to deregulate and at what level to cap prices until then.

We believe this proposed market-based approach to regulating access charges in the absence of competition offers a significant step towards deregulation (and ultimately competitive markets) and we commend the Commission for considering this option. Nonetheless, we also believe that this model could in some ways be more deregulatory, and that the proposed rules do not provide a clear-cut path to complete deregulation. As a result, our perspective differs notably from that taken by the Commission.

Specifically, we see little reason for maintaining any regulations on a market in which either actual competitors exist or a significant competitive threat by new entrants exists. Thus, while the NPRM breaks the discussion into potential and actual competition, we believe this division may misrepresent some markets in which the incumbent has no market

⁸ NPRM, Para. 163-4.

power, and thus truly warrant deregulation.

Recognizing this issue, the NPRM asks whether an incumbent should be required to have a competitor present in its market prior to qualifying for Phase 2 regulatory reform, or if "an incumbent LEC should instead be eligible for Phase 2 treatment if it has made its facilities and services available in a reasonable and nondiscriminatory fashion, but no competitors have entered to serve the incumbent LEC's service area."⁹ We believe that a market sufficiently open to competitors need not and should not remain regulated.

We observe that this approach is largely consistent with the theory of contestable markets.¹⁰ In short, contestable markets theory offers an important message to those involved in public policy, as its chief proponents -- Professors William Baumol, John Panzar, and Robert Willig -- make clear:

"(P)otential competitors, like currently active competitors, can effectively constrain market power, so that when the number of incumbents in a market is few or even where only one firm is present, sufficiently low barriers to entry may make antitrust and regulatory attention unnecessary. Indeed, their costs and the inefficiencies they cause may then offer little or no offsetting benefit."¹¹

Corroborating our point from the above discussion, this perspective notes that regulation may often create significant inefficiencies, and ultimately do more harm than good.

Of course, the theory of contestable markets requires potential competitors who can

⁹ NPRM, Para. 164.

¹⁰ Baumol, William, John Panzar, and Robert Willig, Contestable Markets and the Theory of Industry Structure, Harcourt Brace Jovanovich, San Diego, 1982. See also, Bailey, Elizabeth and William Baumol, "Deregulation and the Theory of Contestable Markets," Yale Journal on Regulation, Vol. 20, No. 2, 1984, pp. 11-37.

¹¹ Baumol, Panzar, and Willig, p. 498.

legitimately challenge an incumbent. Indeed, Professors Baumol, Panzar and Willig have emphasized this point, and have argued that important roles remain for regulators in markets that are not contestable.¹² While Citizens for a Sound Economy Foundation does not disagree with this position, we note that the proposed requirements outlined in Phase 1 of the NPRM may very well satisfy the requirements of contestability. That is, in order to reach Phase 1, which leads to a particular level of deregulation, an incumbent local exchange carrier must have met a series of requirements that allow for cost-based interconnection and/or resale. The ability of alternative providers to interconnect or resell should substantially limit an incumbent's market power. If so, the recommendations of contestable markets theory -- no intervention in markets that meet this criteria -- should be followed.

In addition, we believe that competitive pressure from alternative providers may exist even if the incumbent enjoys a very large market share. In the instant proceeding, the Commission notes that it had previously found in the *Price Cap Second FNPRM* that a large market share did not necessarily confer market power on AT&T in the interstate, interexchange marketplace.¹³ Citizens for a Sound Economy Foundation maintains that the Commission was correct in reaching this conclusion in the long-distance market, and it would be correct to do so in the market for access to the local exchange services that are sold to interstate, interexchange carriers.

Significantly, at least one long-distance service provider argues that competition from alternative providers -- especially non-facilities-based providers -- is not sufficient to justify

¹² Baumol, Panzar, and Willig, pp. 486-7, 498-9.

¹³ NPRM, Para. 158, and *Price Cap Second FNPRM*, 11 FCC Rcd at 922.

deregulation of access charges, and that facility-based competition is required to do so.

According to this criticism, the "market approach only works if there are facilities-based competitors, but facilities can't be built overnight."¹⁴ But the fact is that competition can occur without facilities-based competitors, if those competitors that currently exist have interconnection or resale agreements that sell unbundled elements at sufficiently low prices.

To illustrate how this competition may occur, consider a market with an incumbent that has established sufficient resale and interconnection agreements to meet the criteria of Phase 1. Such a provider would be eligible for a certain level of deregulation under the proposed NPRM's standards, and full deregulation under the standards we have proposed. (Remember, a provider that has not established similar agreements would not be so eligible.) If this incumbent provider now attempts to exert market power by raising the access fees it charges to AT&T, MCI, or Sprint to significantly above-cost rates, alternative carriers can use their existing agreements -- which include cost-based pricing of network elements -- to undercut the incumbent and take market share.¹⁵ This serves as an effective check on the incumbent's attempt to exercise market power.

Finally, the instant proceeding also discusses and asks for comments on other potential measures of market power, including the responsiveness of demand and the responsiveness of supply to various factors.¹⁶ In addition to noting that a substantial body of

¹⁴ Communications Daily, January 24, 1997. Comments of Jerry Salemme, Vice-President of Federal Government Affairs, AT&T.

¹⁵ As stated earlier, these interconnection and resale requirements are part of the requirements that must be met to achieve Phase 1 deregulation in the Commission's proposed model. NPRM, Para. 163.

¹⁶ NPRM, Para. 156-7.

research on such factors already exists in the literature, we note that we are in general agreement with the Commission's statement that "(a) company that enjoys a very high market share will be constrained from raising prices above cost if the market is characterized by high supply and demand elasticities at prices even slightly above competitive levels."¹⁷

At the same time, we are concerned that responsiveness of demand, as measured by elasticity, might be used to support continued regulation in the presence of significant competition. In other words, pleas for continued regulation of access service might be based more on customers' unwillingness to change carriers (absent large price increases) and less on the ability of new entrants to offer a competitive alternative (e.g., through reselling or interconnection). We reiterate that the primary criteria for determining the competitiveness of a market should be the ability of alternative providers to offer service, not some measure of the market share held by alternative providers.

IV. Conclusion

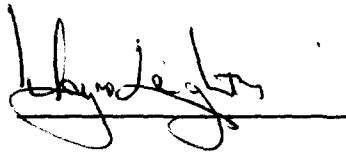
The instant proceeding offers an important opportunity to reassert one of the most important goals of the Telecommunications Act of 1996: deregulation and the emergence of competitive markets. Citizens for a Sound Economy Foundation commends the Commission for acknowledging the importance of this goal and giving it such a significant role in this proceeding. We urge the Commission to act rapidly to remove regulatory structures that are not necessary when incumbents lack market power and competitors exist. In addition, we

¹⁷ Ibid, and Interexchange Order, 6 FCC Rcd at 5887.

note that competitive threats may take many forms, and that a single-minded focus on market share misses the point of competition and the significance of potential entry.

As to those markets remaining under regulation, we believe that the choice of regulatory structure has significant consequences. Regarding the Commission's proposed approaches to transitioning to a more efficient pricing structure, we believe that a market-based approach will be the most successful, both for transitioning to a competitive market and for minimizing the inefficiencies created until such a deregulatory state is reached.

Finally, we recognize that many markets for access service have little if any competition. The approach taken for the transition -- market-based, prescriptive, or other -- is, therefore, important. At the same time, we should not lose sight of the end game -- a competitive market. And we should recognize that regulation is antithetical to competitive markets and the best interests of consumers.

A handwritten signature in black ink, appearing to read 'Wayne Leighton', with a horizontal line drawn underneath it.

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January 28, 1997

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